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Will Ukraine's high real GDP growth continue? New ICPS economic forecast

The high real GDP growth rate shown by the Ukrainian economy since early 2003 will gradually slow down, due to a significant slump in agriculture and reduced global prices. The year 2004 will see a fall in investments prior to the presidential election; nevertheless, it will be more beneficial for Ukraine's economy, thanks to higher GDP growth and reduced inflation. This forecast is unveiled in ICPS's new issue of Quarterly Predictions, which is coming out next week. Starting with this issue, Quarterly Predictions will include a new section titled "Politics", which will offer an analysis of the impact of foreign and domestic policy upon Ukraine's economy

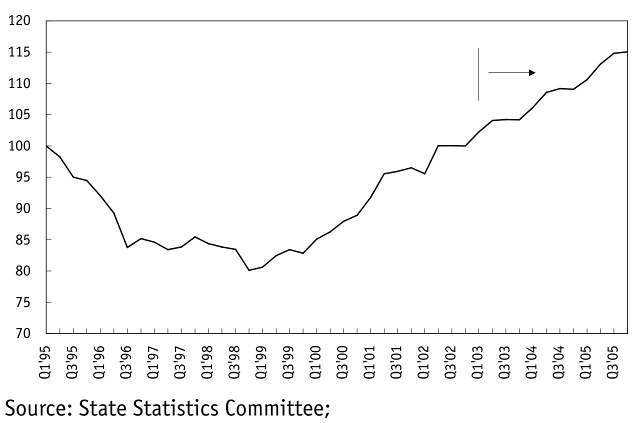
The rapid growth of Ukraine's economy in early 2003 can be attributed primarily to a better price situation in global markets, as well as intensified competition in the most developed sectors of the domestic economy. We believe that these factors will have a multiplied effect on consumption and investment during 2003–2005, and therefore we have upgraded our forecast for this period. We forecast that the conflicts between the government and opposition in Ukraine will become fiercer at YE'03 and particularly in 2004, which will make it harder for the government to pursue effective policy and will stymie economic growth. After the 2004 presidential election, the battles between top political groups will ease off, facilitating the enhancement of economic policy.

Record-high growth rate

During January-April 2003, the Ukrainian economy grew by 7.1% in real terms, which perceptibly exceeds the GDP growth rate in 2002. We are of the opinion that the factors of this rapid dynamic were the following:

- a better price situation in global markets (primarily, those of ferrous metals and chemicals), which sparked accelerated production growth in export-oriented Ukrainian industries;
- intensified competition in the most developed sectors of the domestic economy, in which government interference is comparatively low (namely, food industry, retail trade, pulp&paper and printing industry, the output of which has increased swiftly over several years in a row), which resulted in more investments to boost productivity;
- a much longer and colder winter than last year, which triggered a significant surge in energy, gas, and water production and distribution (11.6% more than in January–April 2002);
- gains in construction, thanks to increased bank lending for housing starts, as well as investment in construction and assembly works made by metallurgy and retail enterprises.

Figure 1. Real GDP Index, seasonally adjusted, Q1'95=100



Source: State Statistics Committee; calculations and forecast by Quarterly Predictions.

Political battles will stymie economic policy

During January–April 2003, the strengthened system of cooperation between pro-government political and economic groups that was created last year allowed Prime Minister Yanukovych's government to pursue economic reforms more vigorously than Kinakh's government did. Specifically, this government has advanced significantly in the accession negotiations with member countries of the World Trade Organisation (WTO), improved relations with the USA and the EU, persuaded the FATF to lift its sanction, and replenished the budget. The tax reforms moved ahead as well; the Verkhovna Rada adopted a law setting a single personal income tax rate at 13%, and promulgating the taxation of passive revenues (interests on deposits, revenues from property sales, etc.) starting in 2004 to expand the tax base.

In this issue of Quarterly Predictions:

- How will the pre-election situation affect the quality of economic policy?
- Will there be a single pro-government nominee running for presidency?
- Outcomes of the individual income tax reform in Russia: Lessons for Ukraine;
- When will the liberalisation of Ukraine's financial market happen in line with WTO requirements?
- Reasons for the steep inflation in early 2003;·
- What would creation of the Common Economic Area mean for Ukraine?
- Do Ukrainian instant coffee producers require protection?
- Ways of reforming housing and public utilities;
- Reasons for deficit in the food grain market;
- Genetically modified organisms: for or against?
- Changes in labour productivity in Ukrainian agriculture and industry.

At the same time, government interference in the economy increased, especially the use of administrative pressure (particularly in the fuel and energy sector and in agriculture). These decisions testify to the poor understanding by the government of what it should do in order to conduct effective economic policy.

We predict that the sharply intensified battles between key political forces starting in Q4'03 and lasting till the presidential election in autumn 2004 will stymie the realisation of quality economic policy, since different interest groups will block each other's initiatives in the parliament through political motives. The government will be prone to adopt short-term populist decisions intended to win voters' support. Under such circumstances, the government will shelve crucial decisions regarding further tax reform measures (especially cutting tax benefits), reform of the infrastructure and coal-mining sectors, alignment of Ukrainian legislation with WTO norms, and the replacement of social benefits with targeted subsidies.

Furthermore, tense battles for the president's chair will force the government to counteract business rivals during the election. Risks of forced property re-distribution will heighten, which will prompt enterprises to postpone investment decisions from 2004 to 2005; this will curb investment growth.

After the 2004 elections, the battles between key political groups will ease off regardless of the winner, who will have to seek majority support for conducting effective policy prior to the 2006 parliamentary election. We forecast a greater urgency with regard to necessary economic reforms, though their rates and quality will depend on who the new president is.

Upgraded forecast for 2003–2005

In view of the factors behind Ukraine's economic growth January through April 2003, we have upgraded our 2003 forecast for the real GDP growth, to 4%. We believe that in H2'03 the GDP dynamic will grow more slowly, because of the following factors:

• decreased production in agriculture (by 3% in annual terms, with the crops component falling by 8%), in view of a smaller grain harvest than last year. The livestock sector will also grow at a slacker pace, because of the more expensive fodder in the domestic market, and thus it will not be able to offset the decline in the crops sector;

• slower growth of global prices will lead to a decline in Ukraine's export growth rate, thus trimming the trade balance.

A decline in grain supply in early 2003 and the forecasted smaller harvest prompts us to boost our forecast for inflation in 2003, to 7.5% Simultaneously, given a bigger positive current account balance, we predict a smaller hryvnia depreciation this year, and a surge in NBU currency reserves.

We have bettered our forecast for GDP growth in both 2004 and 2005, in view of the multiplied effect of changes in 2003, as follows: higher profits of export-oriented sectors will trigger greater investment growth and raised wages of workers employed in these sectors.

In 2004, growth of the Ukrainian economy will accelerate to 4.5%, spurred by growth in both private and public consumption:

• household consumption will pick up at a higher rate, thanks to accelerated income growth (in particular, wages will rise, primarily thanks to a cut in the personal income tax rate and a raise in the minimum wage starting 1 December 2003; also, there will be more social benefits paid out prior to the presidential election;

• accelerated public consumption will be triggered by the government's decisions to increase social payments to citizens to win voter support for the government-backed nominee for president.

In 2005, we predict further acceleration of GDP growth to 5%, primarily thanks to a more rapid increase of investments, in view of the following factors: (1) reduced risks of property re-distribution compared to prior to the presidential election; and (2) enterprise liquidity will enhance, thanks to a cut in the corporate profit tax and an increase in the norms of depreciation deductions in 2004. Investment acceleration will trigger higher growth in the import of machinery and equipment.

We believe that in 2004, an expansive monetary and fiscal policy in Ukraine will perceptibly affect price levels in the following year; in 2005, we predict a consumer price growth accelerated to 5.5%. In 2004, according to our forecast, inflation will amount to 4%; it will be curbed by increased competition in retail trade, and by administrative pressure aimed at achieving price stability in Ukraine's regions.

We predict that in 2003, high inflation and hefty foreign debt payments will thwart the liberalisation of the financial sector by the NBU, which is one of the key requirements of the World Trade Organisation. In our opinion, the National Bank will reduce restrictions in the sector during 2004–2005, right before the WTO accession.■

If you wish to receive the Quarterly Predictions, please contact Maksym Korepanov at tel.: (38-044) 236-5464 or e-mail: marketing@icps.kiev.ua. You may also order ICPS publications through the centre's web-site http://www.icps.com.ua/eng/pub/ or you may purchase an electronic version of any ICPS economic publication in our Internet shop at http://www.icps.com.ua/eng/store/

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To be included in the distribution list mail to: marketing@icps.kiev.ua.
ICPS Newsletter editor Yevhen Shulha (shulha@icps.kiev.ua)
Phone: (380-44) 236-4477, Fax (380-44) 236-4668
English text editor D. (Ksenia) Ovcharenko.

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Address: 13-a Pymonenko Street, Kyiv 04050, Ukraine
Web-site: http://www.icps.kiev.ua